

**Statement of the Investment Company Institute
Hearing on Certain Expiring Tax Provisions
Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives**

April 26, 2012

The Investment Company Institute (“ICI”)¹ appreciates the opportunity to describe for the Subcommittee the reasons why temporary tax provisions impacting the competitiveness of U.S. regulated investment companies (“RICs”) should be made permanent. These provisions reflect sound policy judgments made by this Subcommittee and the Congress on fundamental structuring issues impacting the ability of RICs, more commonly known as mutual funds, to compete with foreign funds for foreign investors.

The ICI applauds the Subcommittee for examining carefully all expiring provisions and seeking to make permanent those that achieve important long-term objectives such as spurring economic growth and job creation and enhancing the competitiveness of U.S. businesses in the global marketplace. The provisions discussed below achieve these objectives by exempting foreign investors in a RIC from U.S. tax on certain amounts that would be exempt if received directly by these investors.

The ongoing temporary nature of these provisions (enacted in 2004 and extended twice), however, limit their usefulness. Making permanent these provisions would enhance substantially the attractiveness of RICs to foreign investors. Making this change expeditiously would be particularly beneficial because withholding must be imposed on all distributions made after these provisions expire (which already has happened, as discussed below, for shareholders of many RICs).

Background

RICs in the Global Marketplace

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.3 trillion and serve over 90 million shareholders.

Individuals around the globe are becoming increasingly attracted to funds to meet their diverse investment needs. Worldwide mutual fund assets totaled \$23.13 trillion as of September 30, 2011.² The U.S. industry's share of worldwide fund assets has declined. As of September 30, 2011, less than half of the worldwide mutual fund assets (\$11 trillion) were in RICs.

RICs offer numerous advantages that should be attractive to foreign investors. In addition to the expertise provided by the industry's portfolio managers and analysts, particularly with respect to the U.S. capital markets, the U.S. securities laws provide strong investor protections. Foreign investors' holdings of RICs, however, are negligible.

The Internal Revenue Code ("Code") creates certain competitive difficulties for RICs seeking to compete with foreign funds for foreign investors. These difficulties arise because RICs are corporations that distribute their income annually as dividends. While income and capital gains are not subject to U.S. withholding tax under section 1441³ when paid to a individual investor who is neither a citizen nor resident of the U.S. (a non-resident alien), dividends are subject to this withholding tax. Thus, absent a Code provision providing that the tax character of this income "flows through" to its investors, RIC shareholders are subject to withholding on certain amounts that would be exempt from withholding tax if received directly by foreign investors.

The Code does provide flow-through treatment for the long-term capital gains realized on RIC portfolio transactions. Specifically, the Code treats distributions of long-term capital gains as a "capital gain dividend;" this flow-through provision exempts a non-resident alien investor from U.S. withholding tax on a RIC's long-term capital gains.

No comparable flow-through solution is provided for interest and short-term capital gains. The flow-through treatment for these types of income, as discussed below, is provided only by the expiring provisions.

Section 871(k)

Section 871(k) was added by the American Jobs Creation Act of 2004⁴ to exempt foreign investors in an electing RIC from U.S. withholding tax on "interest-related dividends" and "short-term capital gain dividends." Interest-related dividends are amounts attributable to an electing RIC's U.S.-source interest income; short-term capital gain dividends are amounts attributable to an electing RIC's short-term capital gains. Section 871(k) permits electing RICs to "flow through" to their foreign shareholders the character of this income.

² http://www.ici.org/research/stats/worldwide/ww_09_11.

³ All references to section, unless indicated otherwise, are to Code sections.

⁴ Pub. L. No. 108-357.

Prior to section 871(k)'s enactment, foreign investors in RICs were subject to U.S. withholding tax on amounts attributable to RICs' interest income and short-term capital gains because these amounts were treated under the Code as ordinary dividends.⁵ Conversely, foreign investors are not subject to U.S. withholding tax on interest and short-term capital gains if the investments instead are made directly in the underlying securities or through foreign funds. Because of this disparate treatment, the Congress enacted section 871(k) to level the playing field and encourage foreign investment in RICs.

As originally enacted, however, section 871(k) was effective for only three years, beginning with a RIC's first taxable year beginning on or after January 1, 2005. This section was extended twice, for two years each time, in 2008 and 2010. Thus, section 871(k) currently is set to expire for dividends with respect to tax years of RICs beginning after December 31, 2011.

Section 2105(d)

Section 2105(d) also was enacted by the American Jobs Creation Act of 2004. This provision effectively provides foreign investors in a RIC that has elected section 871(k)'s application with the same estate tax treatment they would receive if they held directly the portfolio securities held by the RIC.

A non-resident alien generally can invest in U.S. debt obligations without any concern that these assets would be treated as property within the U.S., and therefore part of the individual's gross estate subject to U.S. estate tax, should the person die while holding these assets. Prior to section 2105(d)'s enactment, however, if the same investment were made indirectly through a RIC (such as a U.S. Government bond fund), the RIC shares would be treated as property within the U.S. and subject to the U.S. estate tax.

Under section 2105(d), RIC shares owned by a non-resident alien are not treated as property within the U.S. in the same proportion that the RIC's assets would be treated as situated outside the U.S. if held directly by the investor. This proportional determination is made at the end of the RIC's last quarter before the investor's death.

Section 2105(d) thus provides an estate tax "look-through" rule for RIC shares that corresponds to the interest-related dividend flow-through exception of section 871(k). If section 871(k) had been enacted without the corresponding enactment of section 2105(d), the interest-related dividend provision of section 871(k) would not have encouraged RIC investments by any non-resident alien investor with estate tax liability concerns. Section 2105(d), therefore, is an important element of any fundamental structuring initiative to make RICs more competitive in the international marketplace.

⁵ The regular withholding rules continue to apply if a RIC does not elect flow-through treatment under section 871(k).

As originally enacted, however, section 2105(d) was effective only for individuals dying during the three-year period beginning January 1, 2005 and ending on December 31, 2007. This section, like section 871(k), was extended twice, for two years each time. Section 2105(d) in all cases has expired; only individuals who died between January 1, 2005 and December 31, 2011 were covered.

Reasons These Provisions Should be Made Permanent

Section 871(k) and section 2105(d) are important for RICs seeking to compete with foreign funds for foreign investors. The additional investment in RICs, rather than in foreign funds, benefits U.S. money managers (who hire U.S. workers and pay U.S. taxes) and the U.S. capital markets.

These provisions, as discussed above, provide foreign investors in RICs with the same U.S. tax treatment they would receive if they invested directly in a RIC's underlying portfolio securities. In some respects, it should be noted, even these rules do not go far enough to level the playing field. For example, the estate of a foreign investor in a foreign fund will not incur any U.S. estate tax on the fund shares – even if the fund holds only U.S. equities – whereas a foreign investor in a RIC holding the same securities would be treated as having property situated in the U.S. for estate tax purposes.

The temporary nature of section 871(k) and section 2015(d), however, has limited their utilization by RICs and their attractiveness to foreign investors. Many RICs, for example, have been sufficiently unsure of the provisions' long-term viability to incur the significant programming costs for the possibility of only temporary benefits. The sporadic manner in which these provisions have been extended has done little to convince RICs that the benefits will be long-lasting.

Uncertainty also has impacted investment decisions by foreign investors. Many such investors have been unwilling to make long-term investments in RICs without a long-term assurance that the flow-through benefits would be available. Some foreign investors who nevertheless have invested in RICs have redeemed their shares before receiving a distribution that would have been subject to U.S. withholding tax only because section 871(k)'s application had not been extended before it expired. A separate problem arises for those foreign investors who remain in the RIC after section 871(k)'s application has expired. Specifically, these investors can be forced to file U.S. tax returns to recover taxes, on amounts attributable to interest and/or short-term capital gains, that were collected by the RIC on distributions made during the period after section 871(k) expired and before it was retroactively reinstated.

Unlike most other expiring provisions, which generally need not be resolved until taxpayers are preparing to file tax returns, the flow-through provisions involve withholding taxes and should be addressed before they expire.

Proposal

The Internal Revenue Code should be amended to make permanent the flow-through/look-through treatment of sections 871(k) and 2015(d). Specifically, sections 871(k)(1)(C)(v) and 871(k)(2)(C)(v) – which contain the “termination” date for the flow-through of interest-related dividends and short-term capital gain dividends – as well as section 2105(d)(3) – which contains the “termination” date for the estate tax “look through” rule – should be stricken from the Code. These changes will enhance the international competitiveness of the U.S. fund industry, thus encouraging foreign investment in RICs and in the U.S. capital markets.